Internal Revenue Service

memorandum

CC:TL:Br3
DAMustone

date: OCT 12 1988

to: District Counsel, Oklahoma City SW:OKL
Att'n: Glen McLoughlin

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Technical Advice: [redacted]

By Memorandum, dated August 30, 1988, it was requested that we provide technical assistance with respect to the above litigation. The issue involved has been discussed with Glen McLoughlin of your office.

ISSUE

(1) Whether petitioners, who (as participants in a nonqualified deferred compensation plan) elected to take distribution in installments rather than in lump sum, were in constructive receipt of the entire benefit under I.R.C. § 451 at the time the lump sum would have been payable.

FACTS

The subject cases arise out of a Technical Advice Memorandum issued by the National Office with respect to the [redacted] maintained by [redacted], a privately held Company, for its key executives. TAM 8632003. Under the plan, the participants receive deferred compensation units, called [redacted] shares. See [redacted] The value of these shares is derived from the appreciation of the company's common stock after issuance -- specifically, the cumulative earnings per share (less cumulative losses and dividends). See id., § [redacted]

The vesting of participant benefits is based on a [redacted] schedule ([redacted]% after [redacted] years of service with [redacted]% for each year thereafter). See [redacted] Full vesting will also occur: [redacted] (2) at termination of employment at (or after) age [redacted]; (3) in the event of total and permanent disability; and (4) at liquidation or merger. See id. In addition, participants are permitted to surrender all or a portion of their vested shares at any time. See id., [redacted] All shares, however, must be surrendered either upon termination or upon liquidation or merger. See id., [redacted]

In general, the plan provides that distribution is to be made in the form of a lump sum, unless a participant elects (before the applicable surrender date) to receive [redacted] equal annual installments. See Plan, [redacted]. As implemented by the [redacted] - the committee responsible for administering the plan (see id., [redacted], the participant may alter his settlement election at any time, but the change will not be effective until the next taxable year.1/

Based upon the Technical Advice Memorandum, the participants who elected the installment option were treated as being in constructive receipt of the entire benefit in the taxable year in which it would have been received had that option not been elected.

DISCUSSION

Under § 451, the amount of any income item shall be included in the taxpayer's gross income for the taxable year in which that item is received. Treas. Reg. § 1.451-1(a) provides that for a cash method taxpayer, amounts are included in income when they are actually or constructively received. Under the constructive receipt doctrine, it is well established that a taxpayer cannot deliberately turn his or her back on income and select the year of inclusion. See, e.g., Gullet v. Commissioner, 31 B.T.A. 1067, 1069 (1935); Rev. Rul. 60-31, 1960-1 C.B. 174, 178. In general, a taxpayer is in constructive receipt of income in the taxable year

> during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw has been given ....

Treas. Reg. § 1.451-2(a). At the same time, income is not constructively received where it is subject to substantial limitations or restrictions. See id.

With respect to contracts of deferral, it has generally been the position of the Service that such elections (and elections as to the time and manner of payment) are sufficient to postpone receipt so long as the election is made before the amounts have been earned. See, e.g., Rev. Rul. 69-650, 1969-2 C.B. 106. The instant litigation, however, involves deferrals which were unilaterally made by participants after the [redacted] (and increments thereon) had been credited to participant accounts and

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1/ In two instances, however, this rule was not followed. Thus, the elections made by [redacted] and [redacted] in [redacted] were treated as effective in that year.

those interests had become fully vested. In these circumstances, the election should not, in theory, be sufficient to avoid constructive receipt, since the "right to receive was not restricted, and [the] failure to receive resulted from exercise of [the participants] own choice." Gullett, supra, at 1069. See, e.g., Schniers v. Commissioner, 69 T.C. 511, 516 n.2, & 517-518 (1977).

In your August 30, 1987 memorandum, concern is expressed as to the decisions of the Tax Court in Oates v. Commissioner, 18 T.C. 570 (1952), aff'd 207 F.2d 711 (7th Cir. 1953), acq. 1960-1 C.B. 5, Veit v. Commissioner, 8 T.C. 809 (1947), acq. 1947-2 C.B. 4 (Veit I) and Veit v. Commissioner, 8 T.C.M. 919 (1949) (Veit II). In our view, these cases are distinguishable. In Veit I, the payments were deferred under a bona fide arm's length agreement with the employer prior to the time the amounts were fixed and payable. Id., 8 T.C., at 818. In Veit II, the deferral also occurred pursuant to a legitimate bilateral contractual arrangement with the employer. Id., 8 T.C.M., at 922. And, in Oates, the agreement to defer the receipt of commissions from renewal premiums to be provided following retirement was entered into prior to the time that the amounts involved were in fact earned and before these amounts could be determined. Id., 18 T.C., at 584-85. In contrast, the installment option elections at issue here occurred after the subject amounts were earned. At the same time, these elections were unilaterally made by participants. Therefore, application of the constructive receipt doctrine is not foreclosed by the preceding decisions.2/ See also Williams v. United States,

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2/ Concern was also expressed in your memorandum as to the effect of § 132 of the Revenue Act of 1978 (P.L. 95-600), which provides that the deferral of compensation by a taxable entity is to be determined in accordance with the principles set forth in regulations, rulings and judicial decisions which were in effect on February 1, 1978. This provision was designed to nullify proposed Treas. Reg. § 1.61-16 which was published in the Federal Register for February 3, 1978. See H.R. Rep. No. 95-1445, 95th Cong., 2d Sess. 60 (1978); Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, 95th Cong., 2d Sess. 76 (1979). However, it was not intended to "restrict judicial interpretation of the law relating to the proper tax treatment of deferred compensation or interfere with judicial determinations of what principles [of] law apply ... ." H.R. Rep. No. 95-1445, at 60. Accord General Explanation, at 76. See also H.R. Conf. Rep. No. 95-1800, 95th Cong., 2d Sess. 205 (1980). Thus, § 132 does not restrict further judicial development in this area, so long as it is derived from authorities which were in existence on February 1, 1978. Cf. Knapp v. Commissioner, 90 T.C. 430, 439-41 (1988) (Tax Court does not have jurisdiction to enforce

(continued...)

219 F.2d 523, 527 (5th Cir. 1955) (unilateral escrow arrangement).

(b)(7)a [redacted]

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2/(...continued)
congressional moratorium on certain fringe benefit regulations). Obviously, this is the approach being taken in the instant litigation.

3/ It is our understanding that 2 or 3 cases in the group satisfy this criterion. As was agreed between David Mustone of this Division and Glen McLoughlin of your office, the final decision as to which ones are suitable "test" cases will be coordinated with the Tax Litigation Division.